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TRENDS IN THE CHINESE NATIONAL BUDGET budget

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DEPARTMENT OF STATE

Division of Research for Far East
OFFICE OF INTELLIGENCE RESEARCH

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TABLE OF CONTENTS

	Page
Summary	iii
I. Review of Budgetary Policy, 1936-46	3
A. Government Expenditures	3
1. Changes in the Level of Expenditure	3
2. The Major Components	5
B. Government Revenues	10
1. General Review, 1936-46	10
2. Revenues from Taxation	12
C. The Budgetary Deficit	19
II. The Present Situation and Future Budgetary Prospects.	21
A. Recent Budgetary Developments	21
B. Future Prospects	25
1. At Current Expenditure Levels	25
2. At Reduced Expenditure Levels	27
3. If Military and Non-Military Zones Were Separated	29

LIST OF TABLES

1. National Government Expenditures in Selected Years, 1936-46	4
2. National Government Revenues in Selected Years, 1936-46	12

SUMMARY

A comparative analysis of China's prewar, war-period, and postwar budgets emphasizes the overwhelming burden imposed by continued civil warfare on the fiscal resources available to the National Government. Current military requirements dominate total expenditures to the relative exclusion of government allocations for urgent reconstruction and economic development needs. In real terms, the volume of resources currently appropriated by the military is more than twice the volume expended by the government during the war with Japan.

Current revenues from taxation are grossly inadequate to finance the present level of expenditures on a stable economic basis. The deficit on current account is being met to a minor extent by proceeds from the liquidation of governmental capital assets originally scheduled to finance reconstruction projects, but the major share of the deficit continues to be financed by an inflationary expansion of currency.

Under these circumstances, the government cannot be expected to improve its fiscal position through policies of "self-help." Potential increases in non-inflationary revenue available to the government under present conditions are not sufficient for stabilization purposes.

Prospects would be appreciably brighter if a domestic stabilization program were to be based on broad administrative reforms affecting both expenditures and revenues. Analysis of the government's military expenditures during 1946 indicates that there is a wide area in which appropriations could be curtailed without significantly affecting the government's military potential. Similarly, revenues would be improved if the existing administrative mechanism could be overhauled. In view of the magnitude of the problem and the need for immediate action, the government's ability to meet these prerequisites for fiscal improvement is questionable.

TRENDS IN THE CHINESE NATIONAL BUDGET[1]

In recent statements regarding China's need for US aid in general and for the proposed Export-Import Bank loan of US $500 million specifically, officials of the Chinese National Government repeatedly have taken the position that such aid would be used exclusively for the reconstruction of China's economy. Fiscal problems associated with China's inflation, they assert, would be met by domestic measures and would not siphon US funds from reconstruction and economic development requirements. The following statements are typical of this general position:

1. "The problem of how to meet the budget deficit of the Chinese Government is certainly a difficult one but the government should not depend upon foreign assistance in order to meet that deficit. We must endeavor to meet it by a gradual increase in revenue, by stringency in non-productive expenditures and by domestic loans....There is no need for me to amplify that the government will strictly follow the principles laid down in the common policy program of all parties now participating in the government, namely that foreign loans will be used only for production and construction purposes and for stabilization and

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1. This report has relied heavily on statistical and other valuable information received from Dr. Frank M. Tamagna of the Federal Reserve Board as well as on Chinese budgetary data received through normal governmental sources.

improvement of the people's livelihood."[1]

2. It is proposed, therefore, that negotiations be started at the appropriate time to enable China to obtain financial aid from foreign countries. But it must be pointed out here that it has never been the intention of the government to make use of foreign loans to offset budgetary deficits. Through such loans, it is only hoped that reconstruction projects during their rehabilitation period will be expedited and economic stability realized."[2]

A meaningful appraisal of this thesis involves assumptions regarding the level of expenditure at which fiscal stability is to be achieved. Can the National Government insure the productive use of foreign aid and at the same time command sufficient resources to fight the civil war on its present scale? Or is a substantial reduction in military expenditures an essential prerequisite for the approximate balancing of governmental revenues and outlays, exclusive of reconstruction requirements?

The following analysis of the National Government's budgetary policy during the war and the immediate postwar periods is directed toward answering these questions. Available budgetary data are in general fragmentary, but they nevertheless afford some indication of the domestic potential for achieving fiscal stability in the near future.

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1. Statement made by Premier Chang Ch'un on May 4, 1947, as quoted in T-997, Nanking, May 6, 1947.

2. Report by Minister of Finance O. K. Yui at the 5th session of the People's Political Council on May 23, 1947, as quoted in FBIB, Daily Report,(FE), June 12, 1947, p. PPP-4, RESTRICTED.

I. REVIEW OF BUDGETARY POLICY, 1936-46

A. Government Expenditures

1. Changes in the Level of Expenditure. In terms of China's size and population, the National Government's expenditures before the war with Japan were not large. Total outlays during the fiscal year ending June 1937 were budgeted at less than CN $1,400,000,000, or approximately US $450,000,000 at the prevailing CNC - US$ exchange rate. These expenditures represented 5 percent of the estimated gross national product during 1936 for China, exclusive of Manchuria.

The "productive" services provided by the government to the prewar economy, however, were relatively few. Military appropriations and debt service charges required over 60 percent of total government expenditures, leaving less than US $200 million for the varied duties of administration, maintenance of public services, and investment in public enterprises.

Both the level and relative composition of governmental expenditures were altered substantially during the war. The extent of these changes is indicated in the comparison of prewar expenditures with those for the period 1940 to 1946 in Table 1. For comparative purposes, official budgetary data have been adjusted for price changes, with the year 1937 as the base. Changes in the level of monetary expenditures adjusted by wholesale price indexes, however, are at best a crude indication of changes in the volume of real goods and services mobilized

by the government in support of its activities. In general, these adjusted data understate the real value of government expenditures because of the following factors:

1. Collection of taxes in kind and compulsory borrowing of grain, begun in 1941, were computed in government expenditures at prices substantially below market prices.

2. Prices rose more rapidly than the pay scales of either soldiers or civilian government employees.

3. No allowance is made for an increasing but indeterminate volume of extra-budgetary goods and services obtained by the government through compulsory or voluntary contributions.

4. Urban wholesale prices, which were used to adjust expenditures during 1940-46 to the base year prices, were generally higher than prices in rural areas.

Table 1: NATIONAL GOVERNMENT EXPENDITURES IN SELECTED YEARS, 1936-46[a]
(In million CN$, 1937 value)

Category	July 1936-June 1937	1940	1941-42 Average	1943-44 Average	1945	1946
Administration and subsidies	276	80	51	36	70	245
Debt service	309	56	28	18	3	15
Reconstruction & government enterprise	203	100	55	25	9	113
Provincial and municipal expenditures	0	0	20	18	12	75
Military expenditures	547	630	414	298	604	1,030
TOTALS	1,335	866	568	395	698	1,478

a. Expenditures during the period 1940-45 have been adjusted on the basis of the Chungking wholesale price index; those for 1946, on the basis of the Shanghai wholesale price index.

It is evident from the above data that total government expenditures for goods and services did not approach the prewar rate until after the war with Japan. Even after allowance is made for the qualifying factors noted above, the continued deterioration in the government's ability to control resources for the war with Japan is apparent. During the period 1940-45, average expenditures, adjusted for price changes, were less than half the prewar outlays. The loss of the coastal area and North China to the Japanese was largely responsible for this deterioration, but it seems probable that the administrative weakness of the government, leading to its over-reliance on an inflationary fiscal policy, was an additional contributing factor.

2. The Major Components. Owing to the nature of the data, the allocation of budgetary expenditures among the categories noted in Table 1 had to be somewhat arbitrary in certain cases. The budgetary account labeled "payments for emergency orders," for example, was almost wholly lumped into "military expenditures"; "reconstruction" appropriations undoubtedly included expenditures arising directly or indirectly out of military needs; and "administration" is largely a catch-all category. Although the resulting breakdown is highly approximate, it nevertheless affords a basis for broad analysis.

a. Military expenditures. During the war period an increasing share of budgetary outlays was allocated to direct military requirements. On the average, however, military expenditures during the period 1940-45 were approximately 10 percent less in real terms than those required during the last peacetime year preceding the war with Japan. In contrast to these figures, the large military outlays required by the National Government in connection with the civil war are striking. During 1946 direct military appropriations accounted for 70 percent of total government expenditures and represented in real terms an expenditure more than double the war-period outlay and almost double the prewar rate. These budgetary appropriations, moreover, do not include the significant volume of direct military aid that China's National Government received from the US in 1946.

The unusually large volume of expenditures attributed to the military in 1946 (CN $4 trillion) is difficult to account for on the basis of reasonable assumptions regarding the pay and supply requirements for a Nationalist army of less than 4 million men. Although available data are insufficient for precise evaluation of these expenditures, the following breakdown affords some indication of the effectiveness with which they were used:

Reported military expenditures, 1946 ------- CN $4 trillion

Assumed requirements for an army of 4 million men:

	Trillion CN $
Pay and allowances	1.1
Food	0.7
Clothing	0.3
Transportation	0.2
Munitions	0.1
Fuel	0.1
	2.5
Balance	1.5
	4.0

The estimates shown above for the major military supply categories are probably overstated because of the following factors: (1) the supply standards assumed are probably higher than those actually enjoyed by the Nationalist army for the most part poorly equipped and ill-fed; and (2) no allowance has been made for the appreciable volume of extra-budgetary supplies requisitioned by the military. The residual "balance," which in consequence is conservative, comprises 40 percent of the total, and only a minor share of this balance can be accounted for by various miscellaneous requirements that cannot be reasonably estimated. Although no definite conclusion can be reached regarding the effectiveness of these expenditures because of the tentative nature of the data, it seems probable that the major portion of this balance can be explained only in terms of incompetent administrative controls over military expenditures resulting in corruption on a large scale. The following practices are

indicative of this incompetence:

1. Annual budgetary estimates at the beginning of the year in practice prove to be grossly inadequate. Branch offices of the Central Bank in areas dominated by military commanders consequently are forced to issue currency to the military on a more or less uncontrolled basis. During 1946, "payments for emergency orders," which probably were outside the scope of strict budgetary control and overwhelmingly represented military appropriations, accounted for half of the total government outlays. This inability to control expenditures adequately would have made possible the reported widespread speculation by military commanders in gold and land.

2. "Rice counts" reported by the military apparently are substantially higher than actual head counts. Officials of the Ministry of Finance, in discussing the magnitude of recent increases in military salaries, cite an army of over 5 million men. According to US intelligence sources, however, the present Nationalist army has fewer than 3 million men.

b. Other expenditures. The pattern of postwar expenditures, exclusive of military appropriations, differs from the prewar "norm" in the following respects: (1) current charges for debt service are relatively insignificant; (2) provincial and municipal governments now require subsidies from the Central Government; and (3) current government expenditures for reconstruction and public enterprise appear to be below the prewar level.

China's foreign and domestic debt before the war with Japan amounted to CN $2.8 billion and required annual service charges for interest and amortization exceeding CN $300 million, or almost 25 percent of total government expenditures. Debt charges shown in

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Table 1 for 1946, however, were insignificant. Although the actual status of the government's current debt burden is not clear, these small service charges appear to indicate that the domestic debt has been largely cancelled through inflation and that much of the foreign debt is not being currently serviced. The debt charges shown for 1946 apparently do not include payments made by the National Government on the Soviet war-period barter agreement or on US Export-Import Bank loans. It is clear, however, that the government's debt service charges in 1946 were substantially smaller than the prewar burden.

Central Government subsidies to provincial and municipal governments during 1946 amounted to approximately 5 percent of total expenditures. In large measure, these subsidies were necessitated by the war-period reorganization of the tax system, which channeled the land tax and other revenues directly to the National Government and reduced the revenue sources that could be tapped by the provincial governments. It is probable, however, that the economic disorganization occasioned in the recovered areas by the continuance of the civil war has contributed significantly to provincial budgetary deficits.

The impact of the civil war on the government's ability to finance and effectuate a significant program of reconstruction and

economic development is reflected in the comparatively small sums allocated for these purposes during 1946. The figures shown in Table 1, however, understate the government's role in this field. Government loans at the low official interest rate granted to both public and private enterprises during 1946 were tantamount to subsidies. Such loans were significant in magnitude but were effected through bank credit expansion rather than direct appropriation. Similarly, the reinvestment of profits in inventories and other forms of working capital by such large publicly owned firms as the China Textile Industries, Inc. was not reflected in budgetary expenditures. In terms of China's large postwar reconstruction and industrialization requirements, however, the government's total contribution during 1946 was extremely limited.

B. Government Revenues.

1. General Review, 1936-46. In the period immediately before the war with Japan, China's fiscal policy was managed on a comparatively stable basis. Receipts from taxes and other revenue sources during 1936-37 covered more than 75 percent of total expenditures. The residual deficit was financed largely through the reorganized banking system.

The prewar financial structure, however, was not sufficiently advanced in its development to withstand the impact of war-period

inflationary forces. Sharply reduced yields from prewar revenue sources, resulting from the loss of productive areas to the Japanese, could not be made up by the new revenue measures adopted by the government during the war. Nor were institutions available that could effectively channel existing pivate savings to government use. In consequence, deficit financing accomplished through note issue came to represent an increasing proportion of total expenditures, thus feeding the war-period inflation and adversely affecting tax yields.

This situation was not improved during the postwar period despite the substantial increase in revenues from taxation and other sources. Sharply increased expenditures arising primarily from the government's prosecution of the civil war actually increased the volume of the deficit in real terms over the war-period level. Under these conditions, the government lost ground in its attempt to stabilize the price structure of the postwar economy.

Revenues during the period 1940-46 in comparison with the prewar "norm" are shown in Table 2. As with the expenditure data previously given, revenues during the period have been adjusted to 1937 prices.

Table 2. NATIONAL GOVERNMENT REVENUES IN SELECTED YEARS, 1936-46[a]
(In million CN $, 1937 value)

Category	July 1936-June 1937	1940	1941-42 Average	1943-44 Average	1945	1946
Taxations:						
Customs	404	6	2	2	1	83
Consolidated tax	153	12	12	13	7	106
Salt tax	210	13	22	26	23	62
Land tax	0	0	6	16	2	23
Direct taxes	8	11	17	18	3	29
Public enterprise	75	5	2	1	neg.	12
Sale of material and property	0	neg.	1	neg.	17	126
Other revenues and miscellaneous taxes	180	169	32	20	6	72
Total receipts exclusive of borrowing	1,030	216	94	96	59	513
Borrowing	305	622	514	317	644	965
TOTAL	1,335	838	608	413	703	1,478

neg. = neglible

a. Revenues during the period 1940-45 have been adjusted on the basis of the Chungking wholesale price index; those for 1946, on the basis of the Shanghai wholesale price index.

2. Revenues from Taxation

a. Customs. Customs duties levied on exports and imports constituted China's single major source of revenue in the prewar period. Foreign supervisory personnel participated in administration of customs,

and the funds collected were in part earmarked for servicing the foreign debt. As indicated in Table 2, customs revenue accounted for 30 percent of the government's total receipts in 1936-37. With the loss of territory to the Japanese during the war, however, revenue from this source declined to negligible proportions.

Restoration of the coastal cities to the government's control and resumption of foreign trade on a significant scale resulted in a substantial increase in customs revenues during the postwar period. In comparative terms, however, the yield from customs duties during 1946 was only 20 percent of the prewar yield. This failure of customs revenues to recover to the prewar level is largely understandable in terms of the following factors: (1) foreign trade subject to duty during 1946 was sharply reduced from the prewar level in terms of both value and quantity; and (2) duties on exports, on which lower rates applied, were abolished in August 1946. In addition, however, analysis of the data indicates that, despite the fact that imports were valued at open-market prices for duty computation, customs yield during 1946 would have been 100 percent higher if the prewar relationship between total revenue and the volume of foreign trade (at c.i.f. values) had obtained during 1946. Although duty-free government imports were undoubtedly larger in relative terms during

1946 the available facts suggest a deterioration in customs administrative standards.

b. Other excise taxes. Consolidated and salt tax revenues, the National Government's other two major sources of tax funds, were also lower in 1946 than in the prewar period. The consolidated tax, covering such commodities as tobacco, sugar, beverages, wheat flour, and cotton yarn, is computed on an ad valorem basis similar to customs valuation and frequently is collected at the production level. Although the number of commodities currently subject to this tax exceeds the prewar coverage, revenues during 1946 in real terms were 30 percent less than prewar returns. It seems likely that the disorganization in productive and commercial activity during 1946 was largely responsible for this relative failure in tax yields.

Salt tax receipts during 1946 appear to be unusually low in view of the probable recovery in salt production during the postwar period. Although important salt-producing areas were under Communist control, the government was able to export salt to Japan on the basis of barter agreements concluded in 1946. Yet receipts from the salt consumption tax during 1946, as indicated in Table 2, were 70 percent below the prewar level.

The government, in general, did not participate directly in the salt industry during the prewar period. Production and

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The government, in general, did not participate directly in the salt industry during the prewar period. Production and

distribution were controlled by local merchants, who either owned the fields or leased them from the government. Duties were collected by the Salt Administration, which included foreign supervisory personnel, and these receipts were in part pledged for servicing foreign debts. Although administrative controls were comparatively effective, the strong influence of local business interests and officials in the industry led to widespread abuses. During the war period, the government operated salt fields and assumed more control over distribution of the product. The present scope of the government's activities in the salt industry is not clear. The government controls the price of salt, but its direct participation in the operation of the fields is supposedly minor. According to the Minister of Finance, salt manufacture and distribution are handled mainly by local private interests. Because of the dearth of available information, analysis of the unusually low salt tax yields during 1946 must be highly conjectural. It seems likely, however, that the following factors exerted primary influence in lessening the government's receipts from its "monopoly" position:

1. Government salt exports to Japan were not subject to tax.

2. Government-controlled salt prices rose far less rapidly than the general price index. Consequently, even though tax rates on salt were increased, the yield in real terms was lower than the prewar yield.

3. Revenue leakages and salt smuggling during 1946 probably exceeded prewar levels. Local influences grew more powerful as the controls of the National Government weakened, and, in addition, the supervisory influence formerly exerted by foreign personnel in the Salt Administration was absent.

c. Land tax. Land tax receipts probably constituted the National Government's most important source of war-period tax revenues. This tax was taken over from the provincial government in 1941, and collections were converted from a cash basis to payments in grain. The full importance of this tax to the government is understated in Table 2 because of the budgetary practice of using low official prices rather than open-market prices to value grain receipts. Average annual collections during the period 1941-44 are reported to have exceeded 50 million piculs, an amount that should have been sufficient to feed the army adequately and allow a sizable balance for rationing and price stabilization sales to civilians.

Last year's collections were far below the original quotas, and their importance to the government was more than proportionately reduced. During 1946 the National Government's share in the receipts was cut to 30 percent and administration of the tax was restored to the local governments; payments in certain areas were either forgiven or sharply reduced; and collections in much of North China were

generally impossible to enforce because of the unsettled military situation. In addition, the grain receipts were used less effectively, since the best food collection areas did not coincide with the location of the government's troops and transportation difficulties seriously impeded the movement of government food stocks to required areas. These conditions have become progressively more serious, and the government now finds it increasingly necessary to use compulsory requisitioning as well as its rapidly deteriorating currency to obtain military food supplies in the combat areas.

d. Direct taxes. Direct taxation, apart from the land tax treated above, constitutes a comparatively recent development in the government's fiscal policy. The income tax, first promulgated in 1936, was followed by war-instituted levies on excess profits, inheritances, and business sales and capitalization. Total receipts from all forms of direct taxation, however, were relatively small both during the war and the immediate postwar periods. During 1946 direct tax receipts represented approximately 5 percent of total revenues exclusive of borrowing and covered only 2 percent of total government expenditures.

The apparent inability of the government to obtain control over a significant volume of goods and services through direct forms

of taxation is not surprising. The industrial sector of the economy to which such taxes primarily apply is comparatively small; numerous commercial and manufacturing firms do not employ modern accounting practices, which are an essential prerequisite for the effective collection of direct taxes; and the government does not have sufficient administrative personnel competently trained for proper tax enforcement. To these underlying difficulties, moreover, must be added the deteriorating effect on tax yields of continued currency depreciation. Because of the nature of these taxes, the lag between rate establishment and actual collection is comparatively great. Since tax rates invariably understate the effect of future inflation, tax yields in real terms tend to be seriously reduced through the continued fall in currency values.

e. Capital Liquidation. In addition to various miscellaneous taxes, voluntary contributions, and other revenues of relatively minor importance, the government during 1946 received substantial sums from the sale of gold, foreign exchange, and enemy property taken over from the Japanese after the war. These receipts, included in Table 2 under "sale of material and property," constitute a non-inflationary method of financing current expenditures, but they are not a regularly recurrent source of government revenue. They

represent, in effect, the dissipation of governmental capital assets originally earmarked for the financing of postwar reconstruction projects.

Valuation of these non-recurring revenues during 1946 is subject to some question. According to the budgetary data shown in Table 2, "sale of materials and property" accounted for approximately CN $125 million (1937 value), or 24 percent of "total receipts exclusive of borrowing" and 9 percent of total revenues including borrowing. Other sources indicate that gold and enemy property sales alone amounted to approximately CN $400 million (1937 value). In either case, it is clear that these revenues were significant in 1946. Their future magnitude, however, will depend largely on the ability and willingness of the government to absorb private capital in the industrial enterprises that it is now operating.

C. The Budgetary Deficit

With tax revenues progressively deteriorating in relation to expenditures during the war period, deficit financing became the dominant component of the government's fiscal policy. On the basis of the data shown in Table 2, "borrowing" averaged 85 percent of total expenditures during the period 1940-45. Despite the improvement in revenue prospects brought about after VJ-day, the government still found it necessary to resort to deficit financing for 65 percent of its total expenditures in 1946.

The major part of these large sums required by the government could not be financed from voluntary savings in the hands of the public. Savings institutions were not sufficiently developed, and the credit of the government was too weak. Consequently, these funds were almost exclusively obtained through increased note issue, which enabled the government to compete for its required goods and services with currency in the hands of the public. During the period 1937-46, "borrowings totaled almost CN $5 trillion, of which 75 percent is reflected in increased note issue. The effect of this huge currency expansion on the price structure was inevitable: the general index of wholesale commodity prices rose 3,800 times over the prewar levels. An inflationary levy on the public was substituted for other fiscal measures that would have voluntarily reduced public consumption.

The 1946 deficit amounted to CN $950 million (1937 value), or more than three times the prewar deficit. Its valuation in US dollars is subject to wide limits. On the basis of the prewar CNC-US$ exchange rate, adjusted for subsequent wholesale commodity price changes in the two countries, the deficit in 1946 would amount to over US $400 million; computed at the average official exchange rate prevailing in 1946, it would amount to almost US 1,400 million.

An additional valuation of the deficit, and one perhaps more appropriate for present purposes, may be obtained through use of the average open-market price for gold during 1946. On this basis, the government could have absorbed currency equivalent in value to the deficit through gold sales amounting to US $700 million. To the extent that sales of this magnitude would have reduced the open-market price for gold, this valuation represents and understatement. It is, nevertheless, a crude indication of how much foreign aid would have been required to achieve fiscal stability during 1946, assuming reasonably effective channels for the utilization of such aid.

II. THE PRESENT SITUATION AND FUTURE BUDGETARY PROSPECTS

A. Recent Budgetary Developments

Total government expenditures for 1947 were originally budgeted at CN $9.3 trillion, or an amount approximately equal to last year's expenditures at prices prevailing in January 1947. According to official statements, military appropriations were to be reduced to less than 40 percent of this total, while allocations for reconstruction and rehabilitation were to be increased to more than 30 percent. At face value, this would have meant a cut in military appropriations of almost 50 percent from the 1946 level. Revenues were estimated at more than 70 percent of total expenditures.

Available data covering the first six months of 1947, however, indicate that the government has fallen far short of meeting its budgetary goals. Monetary outlays for the first half of the year were over CN $10 trillion, exceeding the original budgetary estimates for the whole year, and expenditures for the month of June 1947 increased to an annual rate of more than CN $32 trillion. Revenues for the period covered approximately 40 percent of expenditures.

The deficit of over CN $6 trillion for the first six months of 1947 is reflected wholly in bank note expansion. Currency outstanding at the end of June 1947 had increased 165 percent since the beginning of the year, reaching a total of almost CN $10 trillion, and prices continued to rise at an accelerated rate under this impetus. The index of Shanghai wholesale commodity prices increased 4½ times during the first six months of 1947, as against a threefold increase in the comparable period of 1946.

In the light of these data, it is apparant that the leaders of China's National Government thus far have failed in their repeatedly stated determination to reduce expenditures and achieve fiscal stability. Despite the supposedly stern economic measures invoked during the financial crisis of February 1947, expenditures, revenues, and the residual deficit in real terms were approximately equal to

to the levels reported for 1946. Although no breakdown of these recent budgetary data is available, it appears probable that military requirements, impelled by the accelerated tempo of the civil war, continue to dominate the government's outlays for goods and services. Apart from temporary repairs to railway lines cut by the Communists, little evidence exists of any significant reconstruction projects undertaken by the government.

B. Future Prospects

1. At Current Expenditure Levels. If government expenditures are maintained at the present high rate, prospects of fiscal improvement are extremely dim. The full burden of these expenditures is not subject to precise analysis but can be roughly assayed in comparative terms. Prewar government expenditures represented 5 percent of an estimated gross national product (for 22 provinces, excluding Manchuria and the outlying areas) that was derived largely from agriculture. In view of China's low living standards and savings potential, this represented a significant charge for primarily non-productive services. Current government expenditures, however, are 10 percent above the prewar level in real terms, while the gross product in government-controlled areas has been considerably reduced. The tonnage of all agricultural crops in the 22 provinces during 1946 was reported to be more than 10 percent below prewar levels; progress

in the reconstruction of mining and manufacturing industries has been spotty and on the whole comparatively small; only one-third of China's prewar railway lines are currently in operation; and an increasing volume of commodities is flowing into non-productive hoards as a hedge against inflation. Since most of these current expenditures are military, the burden they impose on the economy has been substantially increased.

The revenue side of the budgetary balance sheet theoretically could be improved through: (1) increased taxation; (2) a capital levy; (3) sale of bond issues to the public; and (4) sale of government-owned and operated enterprises to private interests. Present conditions, however, drastically limit the first three of the above possibilities, and the fourth although a significant factor in budgetary calculations, is nevertheless temporary and insufficient to meet the fiscal problem confronting the government.

a. Increased taxation. As indicated above, revenues from all taxes in 1946 represented only 30 percent of the deficit. Consequently, a significant percentage increase in tax revenues would not contribute materially to covering the deficit. In fact, the unchecked course of the present inflation, deterioration in the government's control

over its perimeter areas, and the existing level of the government's administrative competence indicate that substantial improvement cannot be expected in real yields from salt, commodity, and direct taxes. In addition, the reduction of imports because of the government's foreign exchange stringency and the increase in smuggling arising out of the government's attempt to control private foreign exchange holdings will adversely affect customs revenue.

b. Capital levy. Discussions among government officials concerning the feasibility of levying a capital tax have frequently been rumored. In June 1947 the National Economic Council reportedly had approved such a tax in principle and was in disagreement only with regard to the rate. The efficacy of such a tax in China, however, is subject to question in view of the relatively small area of the industrial sector, the limited use of banking facilities for private capital accumulations, and the present inflation.

Reasonably good results conceivably might be obtained from a capital tax designed as an adjunct of a currency conversion. In this case, the total yield accruing from the exchange of old currency for new at undervalued rates would be dependent to a large extent on the government's questionable ability to maintain the value of the new currency with its existing resources and under the pressure of its current expenditures. In addition, the postwar experiences of France

and Belgium with this fiscal method indicate that the level of administrative competence imposes a severe limitation on the potential proceeds from such a tax. On a comparative basis, China's National Government would be even more restricted in the scope and effectuation of its tax plans.

c. Sales of government bonds issues to the public. If a substantial portion of the deficit could be financed through the sale of government securities to the public instead of through note expansion, private consumption would be voluntarily reduced and the flow of commodities into speculative hoards lessened. The basic advantage would be a sharp reduction in inflationary pressures. The credit for the government, however, is demonstrably too weak for such financing. On April 1, 1947 the Ministry of Finance offered for sale three-year treasury notes equal in value to US $300 million (at the official exchange rate) to be purchased with CN currency and 10-year bonds totaling US $100 million to be purchased with gold, US dollars, of foreign exchange holdings. Total sales of these securities in three months amounted to only US $25 million, of which a substantial portion was subscribed by the banks.

d. Sale of government-owned enterprises. Included in the Emergency Economic Measures of February 1947 was the announcement that state-owned and operated enterprises, "except those required for

national defense and public health," would be offered for sale to the public as rapidly as possible. Thus far, procedures for their appraisal and sale are still to be worked out. Recent reports indicate that 70 percent of the China Textile Industries, Inc., 50 percent of the China Silk Company, and the entire assets of the China Tobacco Co., and numerous smaller government corporations are earmarked for disposal to private interests. Under optimistic assumptions regarding the methods of sale and the confidence of prospective investors in future operating conditions, the sale value of these companies is not likely to exceed CN $1 trillion (1946 value), or approximately 30 percent of the deficit. Although such an amount would substantially improve the government's fiscal position, its positive effect would be essentially temporary. In addition, it must be pointed out that the program has not as yet been implemented in fact and that, in any event, the present rate of progress indicates that its consummation will be time-consuming.

2. At Reduced Expenditure Levels. Since military appropriations constitute so large a porition of total government expenditures, possibilities for substantial budgetary economies are dependent on the ability to cut military funds. In general, military allocations could be curtailed through (1) improved administrative controls resulting in more effective utilization of appropriated funds and (2) a reduction in the level of military activities.

On the basis of the fragmentary data given above in Part I, it appears likely that a significant portion of military appropriations in 1946 represented leakages. Sharp reductions in expenditures could be achieved by broad administrative reforms aimed at increasing the control of Central Bank authorities over note issue and holding military commanders to stricter accountability for appropriated funds. If, in addition, administrative reform included a wholesale reorganization of the Nationalist Army directed toward lopping off useless divisions in the rear areas and improving supply standards for troops in the combat zones, net appropriations probably would be further reduced. It is conceivable that such a program, as a whole, could reduce military appropriations by one-third, or approximately 40 percent of the current deficit, without significantly affecting the Nationalist war effort. It should be pointed out, however, that in 1946 the government under T. V. Soong, failed in its attempts at administrative form along the lines suggested above.

Prospects for a reduction in the present level of military activities are dependent on political and military factors analysis of which is beyond the scope of this paper. In general terms, however, a military retrenchment program based on strategic withdrawals in certain areas and the consolidation of positions in others probably would not substantially reduce requirements for military goods and

services. The result might be a realignment of opposing forces in the civil war, with the Nationalist armies in a more effective position to withstand continued Communist pressure. A successful program of this nature could improve the government's revenue prospects in areas where Nationalist positions were consolidated and controls strengthened. Land tax receipts, in particular, might be expected to increase, and provincial government deficits consequently might be reduced.

A sharp reduction in expenditures effected wholly or in part by tightening administrative controls would have an indirect as well as a direct positive effect on revenues. The magnitude of the deficit could be lessened and currency expansion in consequence curtailed. Under these conditions, the rate of inflation would be reduced and tax yields thereby improved. Further possibilities for fiscal stability inherent in the potential improvement of the government's credit are apparent in principle but highly conjectural.

3. If Military and Non-Military Zones Were Separated. Recent reports indicate that government officials have been discussing plans for the separation of China into two zones -- military and non-military. Although details have not been advanced, the proposal in its broad outlines presumably envisages the establishment of a new

currency in the non-military zone, along with a program of reconstruction designed to attract the participation of foreign private and governmental capital. In the military zone, inflation would unavoidably continue at an accelerated rate.

The political repercussions of such a program on the ultimate ability of the present National Government to remain power are potentially strong. In principle, the problem involves an assessment of (1) the importance of the national currency as an instrument of the government's power in the military area and (2) the extent to which popular support of the government is dependent upon the fact that it represents an effort to achieve a unified China.

In any case, the program would raise extremely difficult administrative problems. It assumes that two budgets would be politically and militarily better than one. Since fiscal conditions in the military zone would continue to deteriorate, net gains from the program would depend on a marked improvement in the administration of the civil zone. In order to achieve the aims of the program, the authorities in that zone would have to perform the impossible task of continuing the support of the army and at the same time insulating the civil economy. Specifically, their program would involve the establishment of a separate currency, institution of effective trade controls between the two areas designed to prevent a drain of

resources contrary to objectives, and creation of a civil administration providing conditions that would attract capital investment. The National Government as constituted at present, cannot be expected to cope successfully with these difficulties.